

**Better Controls Are Needed to Ensure
Appropriated Funds Are Used to Improve the
Application of the Earned Income Credit**

November 2001

Reference Number: 2002-40-020

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 30, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Better Controls Are Needed to Ensure
Appropriated Funds Are Used to Improve the Application of the
Earned Income Credit (Audit # 200140029)

This report presents the results of our review to determine if the Internal Revenue Service (IRS) expended Earned Income Credit (EIC) appropriated funds for issues, programs, and projects not related to the EIC.

The Congress has been concerned with the IRS' ability to administer the EIC. In 1997, the Congress enacted legislation that authorized the IRS to spend a total of \$716 million over a 5-year period for the improved application of the EIC. The 5-year period began in Fiscal Year (FY) 1998.

Each year, the IRS spends over \$100 million appropriated by the Congress to help ensure that eligible taxpayers claim the EIC and to reduce overclaims and fraud, waste, and abuse. The IRS established the EIC Program Office to administer the EIC appropriation and oversee the EIC-related activities of IRS functions involved in efforts to ensure the efficient application of the law; to increase participation of eligible taxpayers; and to reduce fraud, waste, and abuse. Each year, the Program Office develops a plan that outlines how the EIC funds will be used. However, the IRS does not have an effective process in place to ensure that the expenditure of the EIC appropriation is only for EIC issues, programs, and projects. Our analysis of the total labor expenses for 2 IRS functions and a judgmental sample of the IRS' equipment purchases for FY 2000 and the first quarter of FY 2001 identified approximately \$28 million in questionable expenses.

The IRS is scheduled to receive \$146 million in EIC funds in FY 2002, the last year of the current 5-year appropriation. Without effective controls in place to assure the Congress that the funds are being spent appropriately, the IRS is at risk that future appropriation funding beyond FY 2002 could be in jeopardy. We recommended that

the IRS establish procedures to ensure that funds appropriated by the Congress for the improved application of the EIC are used for that purpose.

The IRS took corrective action on our recommendation. However, we believe the corrective action only strengthens controls for the functions' requests and authorizations to expend EIC funds. The corrective action does not include conducting periodic reviews of actual functional EIC expenditures to ensure they are EIC related. We believe these reviews are critical to ensuring EIC funds are used for EIC purposes. The response also does not address maintaining reliable data to determine how much of the IRS' purchases should be paid for using EIC funds. We believe our recommendation to the Commissioner, Wage and Investment Division, that addresses this issue is still valid.

The IRS disagreed with the value of our reported outcome that \$28 million of EIC funds were used for questionable labor and equipment purchases. However, the IRS did agree with our statements that not all the expenses we reviewed were directly related to the EIC. Therefore, until the IRS has sufficient information to determine how much of these items are directly related to the EIC, we believe our outcome measure is still valid.

IRS management's comments have been incorporated into the report, where appropriate, and the full text of their comments is included as an appendix. We have also addressed specific points in the report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Michael Phillips, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-7085.

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Background

The Earned Income Tax Credit (EIC)¹ is a refundable tax credit created in 1975 to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment rather than welfare. The Congress assigned responsibility to the Internal Revenue Service (IRS) to administer the EIC. The IRS defined this role as ensuring the effective application of the law; achieving full participation² of eligible taxpayers; and reducing overclaims³ and fraud, waste, and abuse. In September 2000, the IRS reported⁴ that \$7.8 billion in EIC claims should not have been paid in 1998 for Tax Year (TY) 1997.

The Congress has been concerned with the IRS' ability to administer the EIC. In 1997, the Congress enacted legislation⁵ that authorized the IRS to spend a total of \$716 million over a 5-year period for the improved application of the EIC. The 5-year period began in Fiscal Year (FY) 1998.

The IRS established the EIC Program Office to administer the EIC appropriation and to oversee the EIC-related activities of IRS functions involved in efforts to ensure the efficient application of the law; to increase participation of eligible taxpayers; and to reduce fraud, waste, and abuse. Each year, the Program Office develops a plan that outlines how the EIC funds will be used. Items the EIC funds are used for include:

- Salaries, benefits, and related costs.
- Improvement of enforcement efforts.

¹ The Earned Income Tax Credit will be referred to as the Earned Income Credit (EIC) in future references in this report.

² Full participation is defined as the number of taxpayers eligible for the EIC compared to those actually receiving the funds.

³ EIC overclaims involve both intentional and unintentional (mistakes) attempts to file returns with EIC claims that fail to meet eligibility requirements.

⁴ This information was based on results from a report on compliance estimates for the EIC claimed on 1997 returns.

⁵ The Balanced Budget Act of 1997, Pub. Law No. 105-33.

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- Improvement of education and outreach activities.
- Enhancement of computer capabilities to identify and select questionable EIC claims.

During FY 2000, the IRS received and planned to spend \$144 million in appropriated funds on the following items:

Fiscal Year 2000 EIC Planned Expenditures

Item	Amount
Labor	
• Cash Awards	\$155,870
• Availability Pay	1,705,525
• Overtime and Holiday Pay	5,338,664
• Pay Differential	30,464
• Salaries	77,963,724
• Personnel Benefits ⁶	20,132,076
• Separation Pay	<u>80,322</u>
Total Labor	\$105,406,645
Travel	1,699,325
Automated Data Processing Equipment, Software, and Operational Costs	22,057,352
Telecommunication	4,325,066
Services and Supplies	10,511,612
TOTAL	\$144,000,000

Source: The Automated Financial System (AFS)⁷ report for the EIC appropriation (0917) for FY 2000.

⁶ Personnel Benefits include the government's share of payroll taxes, retirement plans, and life and health insurance premiums.

⁷ The AFS is the IRS' budget and accounting system. We did not verify the accuracy or reliability of the data provided in this report.

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See Appendix V for more detailed information on EIC spending by the IRS functions.

During FY 2001, the IRS was appropriated \$145 million in funds and is using it to administer approximately \$32 billion in EIC claims expected to be paid to taxpayers in 2001. The IRS is scheduled to receive \$146 million in EIC funds in FY 2002, the last year of the current 5-year appropriation.

In March 2001, the Treasury Inspector General for Tax Administration (TIGTA) reported⁸ that the IRS did not adequately validate its EIC results information, causing the inaccurate reporting of the use of EIC appropriation funds to the Congress. IRS management agreed with our recommendation and planned to take corrective actions to verify the adequacy of information submitted by the functions. We conducted this review as a follow-up assessment of the expenditure of appropriated funds.

This review was conducted in the National Headquarters, the EIC Program Office, the Taxpayer Advocate Service (TAS), Criminal Investigation (CI) office, Information Technology Services, and Wage and Investment (W&I) Division in the Stakeholder Partnership, Education, and Communication function between October 2000 and June 2001. The audit was conducted in accordance with *Government Auditing Standards*.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS does not have an effective process in place to ensure that the expenditure of the EIC appropriation is only for EIC issues, programs, and projects. We analyzed the total labor expenses for two IRS functions and a judgmental sample of the IRS' equipment purchases for FY 2000 and the first quarter of FY 2001. In addition, we analyzed a

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⁸ *Management Advisory Report: Improvements Are Needed to Assess the Use and Impact of the Earned Income Credit Appropriation* (Reference Number 2001-40-064, dated March 2001).

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judgmental sample of 336 travel vouchers totaling approximately \$269,000 in FY 2000 expenditures.

The IRS correctly expended the \$269,000 for EIC-related travel expenses for the vouchers we reviewed. However, we determined that the IRS spent approximately \$28 million (labor and equipment purchases) of the EIC funds on items that could be questioned by the Congress and other stakeholders as being unrelated to the application of the EIC. Specifically we found:

\$9.6 million in questionable equipment purchases

The IRS spent approximately \$30 million in FY 2000 and the first quarter of FY 2001 of EIC appropriated funds to purchase video materials, computer equipment, software, telecommunication equipment, and publications. While some of these purchases were related to the application of the EIC, our review of 46 of 68 purchases identified approximately \$9.6 million in questionable items.

- Approximately \$557,000 was spent to produce a Lamaze⁹ video, entitled *You and Your Baby*, and other related materials. The video was purchased by the Social Security Administration (SSA) using EIC appropriated funds to ensure parents know the importance of acquiring Social Security Numbers for their newborn babies.¹⁰ While the video briefly mentions the importance of acquiring SSNs, the video is primarily an infomercial advertising various commercial products and their use (for example, a breast pump, bottles for formula, and disposable diapers). Therefore,

⁹ Lamaze is a not-for-profit organization of parents and healthcare professionals whose mission is to promote normal, natural, and healthy childbearing and early parenting experiences for women and their families.

¹⁰ The SSA program is referred to as Enumeration at Birth. The IRS' interagency agreement with SSA provides for up to \$10 million for the cost of implementing a section of the Taxpayer Relief Act of 1997 which requires the SSA to obtain both parents' SSNs when applying for the SSN of a newborn.

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we do not believe this purchase should have been made using EIC funds.

- Approximately \$7 million was spent to purchase computer equipment for various IRS volunteer programs to assist low-income taxpayers. These programs helped taxpayers to prepare and file their Tax Year 2000 tax returns. The IRS was aware that not all of the tax returns prepared with these computers had EIC issues but could not effectively estimate the number of assisted taxpayers that would have EIC issues. Documentation provided by the IRS showed the main reasons for purchasing these computers were to support the IRS Restructuring and Reform Act of 1998¹¹ goal of having 80 percent of all tax and information returns filed electronically by 2007 and to increase the accuracy of tax returns prepared by volunteers. Documentation showed no specific relationship to the EIC that justified the use of EIC funds for this purchase. Therefore, we do not believe these reasons justify using EIC funds for this purchase. The documentation showed the EIC funds were to be used to purchase laptop computers, portable laser printers, data projectors, and supplies for the increased number of volunteer program sites that offer electronic filing. The IRS documentation did not specify that the purchases were made to solely focus on assisting taxpayers with EIC issues.
- Approximately \$2 million was spent to purchase computer equipment and software that is used to test the system used by employees to review tax returns for fraud potential. IRS personnel informed our auditors that this equipment is also used to test other systems that are not related to the EIC. Also, employees that use this system do not track the number of returns reviewed that have the EIC. Based on these discussions and our analysis of various IRS functional activity reports (including correspondence between the functions and the EIC Program Office), we could not determine without

¹¹ Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

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reliable data how much of the \$2 million spent for this equipment and software was directly related to the EIC.

- Approximately \$39,000 was spent to purchase computer software that was used to prepare taxpayer correspondence prior to mailing. IRS personnel informed our auditors that this software is used for EIC correspondence as well as other mailings. We believe that EIC funds should not have been used to pay for this software. Documentation provided by the IRS showed that over 1.7 million EIC specific notices and letters were issued to taxpayers during Calendar Year (CY) 2000. The documentation also showed that over 50 million non-EIC specific notices, letters, and tax packages were mailed to taxpayers during CY 2000. While some of the cost to purchase the computer software was related to the application of the EIC, we believe that EIC funds should not have been used to pay for the entire cost of the software.

\$18.4 million in unsupported labor expenses

The IRS spent approximately \$18.4 million in appropriated funds for labor expenses during FY 2000 and the first quarter of FY 2001 in 2 of its functions that we selected for review (see below). While some of these expenses were related to the application of the EIC, neither function had sufficient data for us to determine how much of the \$18.4 million was directly related to the EIC.

- Approximately \$16.2 million of the EIC appropriation was spent by the IRS' CI Fraud Detection Centers (FDC) to review returns in order to identify potentially fraudulent EIC tax returns, refund schemes, and questionable EIC tax return preparers. The FDCs also spent approximately \$9.2 million in labor expenses that were not paid by the EIC appropriation.

While some of the expenses paid by both appropriations were related to the EIC, the CI function does not track the number of tax returns reviewed that contain the EIC. Therefore, the TIGTA could not determine how much of these expenses were directly related to the EIC. Also,

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during FY 2000 and the first quarter of FY 2001, the CI function did not conduct operational reviews to ensure the expenses charged to the appropriation were related to the EIC.

- Approximately \$2.2 million was spent by the IRS' TAS Offices to assist taxpayers with EIC-related problems when the normal processes for resolution failed. At the time of our review, there was no data available for the TIGTA or the TAS to determine how much of these expenses were directly related to the EIC. Also, during FY 2000 and the first quarter of FY 2001, the TAS did not conduct operational reviews to ensure the expenses charged to the appropriation were related to the EIC. However, the TAS did conduct an inventory analysis that reflected it was underreporting the number of EIC cases and time expenditures in the IRS financial system.

The IRS correctly expended EIC appropriated funds for travel expenses

The IRS spent approximately \$1.5 million in appropriated funds for travel expenses. We reviewed a judgmental sample of 336 travel vouchers totaling approximately \$269,000 and found that expenses were directly related to EIC issues.

Federal Laws and Internal Processes

Federal law¹² states that, "appropriations shall be applied only to the objects for which the appropriations were made except as otherwise stated by law." The Standards for Internal Control in the Federal Government state that "internal control systems are to provide reasonable assurance that the objectives of the system will be accomplished." The Federal Managers' Financial Integrity Act requires that revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports

¹² The Purpose Statute, 31 U.S.C. § 1301.

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may be prepared and accountability of the assets may be maintained.¹³

The EIC Program Office is responsible for the initial approval of activities and initiatives that will be paid for using EIC funds. Once approved, the IRS functions are given their portion of the EIC funds to be spent on EIC activities. The functions use their normal procedures for purchasing and approving items.

Contributing Factors

The IRS management and oversight process for the EIC appropriated funds does not include periodic review of functional expenditures because the EIC Program Office believed that it was prohibited from conducting such reviews. Instead, EIC Program Office management relied on the functional offices that requested and received funds to ensure they were being spent appropriately. To maintain some oversight, the EIC Program Office used periodic conference calls with the functions to discuss functional planning, concerns, issues, and use of the EIC funds. During our review, the EIC Program Office announced a planned budget execution review of appropriation funds used during the period of October 1, 2000, through May 25, 2001. As of the date of this report, the IRS had not completed this review.

For FYs 2000 and 2001, the IRS has been appropriated \$289 million to improve the application of the EIC, but it cannot be certain that all funds were or will be spent for EIC-related items. The IRS' adherence to the law could be questioned if EIC appropriated funds were used for items that are not related to the EIC.

Without reliable information or an effective process to oversee the spending of the funds, the IRS cannot assure that it has a clear and accurate picture of whether the funds were

¹³ Federal Managers' Financial Integrity Act of 1982, 31 U.S.C. §§ 1105, 1113, and 3512 (1994 & Supp. IV 1998).

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spent appropriately nor can it make informed decisions about the application of the EIC and the billions of dollars in future EIC claims.

Recommendation

1. The Commissioner, W&I Division, should establish procedures to ensure that funds appropriated by the Congress for the improved application of the EIC are used for that purpose. These procedures should include providing guidance to the appropriate functions on using the EIC-related funds for expenditures, maintaining reliable data, and conducting periodic reviews of the expenditures to ensure they are being used for EIC-related items.

Management's Response: The EIC Program Office redesigned the form used to request the realignment of EIC funds and to request additional resources. The EIC Program Office now requires additional coordination and approvals before authorizing the expenditure of EIC funds. The revised form and procedures have been placed on the Chief Financial Officer website in the FY 2002 Financial Operating Guidelines and discussed with the functional EIC coordinators via conference call.

The IRS disagreed with the value of our reported outcome that \$28 million of EIC funds were used for questionable labor and equipment purchases. The IRS' basis for disagreement was the benefits to tax administration derived from the functional use of EIC funds. Examples of these benefits include a public information campaign, increased number of electronically filed returns, and cost savings from postal discounts and incentives.

Office of Audit Comment: The IRS' corrective action only strengthens functional controls to request and obtain authorization to expend EIC funds. The corrective action does not include conducting periodic reviews of actual functional EIC expenditures to ensure they are EIC related. We believe these reviews are critical to help ensure EIC funds are used for EIC purposes. If not already started, we

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suggest the EIC Program Office conduct the reviews mentioned in the body of the report and ensure it includes an analysis of actual EIC expenditures to ensure they are EIC related.

The IRS also needs to have reliable data to determine how much of its purchases should be paid for using EIC funds. As stated in the report, we could not always determine how much of a purchase was EIC related because the IRS did not have data showing this information. If these data are not available, we believe the IRS should pro-rate purchases that involve non-EIC use rather than paying for 100 percent of the purchase with EIC funds. Therefore, we believe our recommendation to the Commissioner, W&I Division, that addresses this issue is still valid.

While the IRS' basis for disagreeing with our \$28 million outcome was the derived benefits to tax administration, it did agree that not all the expenses we reviewed were directly related to the EIC. As stated above, the IRS did not always have information to determine how much of the purchases were EIC related. Therefore, we believe our \$28 million outcome in questionable EIC purchases and labor charges is still valid.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if the Internal Revenue Service (IRS) expended Earned Income Credit (EIC) appropriated funds for issues, programs, and projects not related to the EIC. To achieve this objective, we conducted the following tests:

- I. Determined if the EIC Program Office had controls to monitor and track funds to ensure the funds expended were EIC related.
 - A. Interviewed EIC Program Office and functional IRS personnel (the Taxpayer Advocate Service (TAS), Criminal Investigation (CI) office, Information Technology Services, and the Stakeholder Partnership, Education, and Communication function) to identify roles and responsibilities related to the EIC appropriation.
 - 1. Identified tools used to track EIC expenditures.
 - 2. Obtained and reviewed the EIC Program Plan for Fiscal Years (FY) 2000 and 2001 to identify initiatives planned by the various IRS functions.
 - B. Reviewed the EIC methodology used by budget execution personnel to calculate direct/indirect expenditures captured on the Automated Financial System (AFS)¹ reports.
 - C. Obtained and reviewed AFS reports for FY 2000 and the first quarter of FY 2001 to identify EIC obligation and expenditure amounts.
 - 1. Stratified AFS reports to determine functional direct/indirect charges, spending office, and types of expenditures.
 - 2. Stratified AFS reports to identify and separate labor/non-labor charges by function and spending office.
- II. Determined if IRS functions had controls to track funds to ensure the funds expended were EIC related.

¹ The AFS is the IRS' budget and accounting system. We did not verify the accuracy or reliability of the data in this report.

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- A. Reviewed travel vouchers to determine if expenses were EIC related.
1. Obtained a download from the Travel Reimbursement and Accounting System (TRAS)² and identified FY 2000 travel expenditures charged to the EIC appropriation.
 2. Stratified TRAS data to identify travel expenditures by employee, function, and office.
 3. Selected a judgmental sample of 336 of 4,950 travel vouchers submitted during FY 2000. These vouchers were selected from 8 offices that had the highest total EIC-related travel expenses within the respective functions and regions. An additional office was selected because of its geographical location to auditors. From these offices, we judgmentally selected employees according to geographical location that had total EIC-related travel expenses greater than \$1,000.
 4. Reviewed the 336 travel vouchers to determine if the travel was related to the EIC. For 155 vouchers where we could not make a determination, we reviewed supporting documentation submitted by employees or management officials to determine if expenses were EIC related.
 5. Discussed questionable vouchers with the IRS to determine why items were charged to the EIC appropriation.
- B. Determined if charges for equipment, supplies, and software were for EIC-related items.
1. Obtained a download from the Requisition Tracking System (RTS)³ and identified 66 FY 2000 requisitions and 2 first quarter of FY 2001 requisitions that were charged to the EIC appropriation.
 2. Selected and reviewed a judgmental sample of 46 requisitions (45 FY 2000 and 1 first quarter of FY 2001). We selected our sample based on our ability to readily determine how the items purchased related to the EIC.

² The TRAS is the IRS' system that processes employee claims for reimbursement for official government-related travel expenses. We did not verify the accuracy or reliability of TRAS data.

³ The RTS is an automated system used by the IRS to build and track requests for certain types of goods and services. We did not verify the accuracy or reliability of RTS data.

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3. Visited and held discussions with functional offices (including Information Technology Services and Stakeholder Partnership, Education, and Communication) to determine if the items purchased were being used for EIC-related issues.
 4. Discussed questionable purchases with the IRS to determine why items were charged to the EIC appropriation.
- C. Determined if \$16.2 million in CI Fraud Detection Center labor expenditures for FY 2000 and the first quarter of FY 2001 were EIC related.
1. Interviewed CI personnel to determine specific roles, responsibilities, and tools/methods used to track labor expenditures and ensure the expenditures were EIC related.
 2. Obtained and reviewed AFS reports to identify EIC obligation and expenditure amounts.
 3. Obtained and reviewed functional activity reports to determine the amount of EIC-related work completed by the FDCs.
 4. Determined if the CI function conducted operational reviews of EIC expenditures.
- D. Determined if \$2.2 million in TAS labor expenses for FY 2000 and the first quarter of FY 2001 were EIC related.
1. Interviewed TAS personnel to determine specific roles, responsibilities, and tools/methods used to track labor expenditures and ensure the expenditures were EIC related.
 2. Obtained and reviewed AFS reports to identify EIC obligation and expenditure amounts.
 3. Obtained and reviewed data from the Taxpayer Advocate Management Information System (TAMIS)⁴ to determine the amount of EIC-related work completed by the TAS offices.
 4. Determined if the TAS conducted operational reviews of EIC expenditures.

⁴ The TAMIS is a management information system that contains Taxpayer Advocate Cases. We did not verify the accuracy or reliability of TAMIS data.

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner N:C
Earned Income Tax Credit Program Office W:EITC
Director, Strategy and Finance W:S
National Taxpayer Advocate TA
Chief Information Technology Services M:I
Chief, Criminal Investigation CI
Chief Counsel CC
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaisons:
 Earned Income Tax Credit Program Office W:EITC
 National Taxpayer Advocate TA
 Chief Information Technology Services M:I
 Chief, Criminal Investigation CI

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Protection of Resources and Reliability of Information - Potential; \$28 million of Earned Income Credit (EIC) appropriated funds (see Page 3).

Methodology Used to Measure the Reported Benefit:

We calculated the \$28 million as follows:

ITEM	AMOUNT
Video Materials and Related Publications	\$ 557,000
Computer Equipment Used to Test Management Information Systems	\$ 2,017,969
Computer Equipment Used for Volunteer Programs	\$ 7,000,000
Computer Software for Addressing and Mailing Correspondence	\$ 39,000
Criminal Investigation (CI) Fraud Detection Centers (FDC) Labor Charges	\$16,200,000
Taxpayer Advocate Service (TAS) Labor Charges	\$ 2,200,000
TOTAL	\$28,013,969

See details below for calculations for each of the above items.

Video Materials and Related Publications - \$557,000. This is the amount the Internal Revenue Service (IRS) provided for a Lamaze¹ video and other related materials and publications.

Computer Equipment Used to Test Management Information Systems - \$2 million. The total cost of this equipment was \$2,017,969.

¹ Lamaze is a not-for-profit organization of parents and healthcare professionals whose mission is to promote normal, natural, and healthy childbearing and early parenting experiences for women and their families.

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Computer Equipment Used for Volunteer Programs - \$7 million. This is the actual cost for this computer equipment. Without a process for identifying reliable information regarding the number of taxpayers assisted involving the EIC, the IRS cannot ensure that these funds were used to improve the application of the EIC.

Computer Software for Addressing and Mailing Correspondence - \$39,000. This is the actual cost of this software.

Labor Charges - \$18.4 million.

Criminal Investigation FDC Labor Charges - \$16.2 million. This is the actual amount of the labor costs for Fiscal Year (FY) 2000 and the first quarter of FY 2001 paid by the EIC appropriation. The FDCs also spent approximately \$9.2 million in labor expenses that were not paid by the EIC appropriation. While some of these expenses were related to the EIC, we are claiming the entire amount paid by the EIC appropriation as an outcome because the CI function did not have data available on the number of EIC returns reviewed. Therefore, we could not determine how much of the \$25.4 million was directly related to the EIC.

Taxpayer Advocate Labor Charges - \$2.2 million. This is the actual amount of the labor costs for FY 2000 and the first quarter of FY 2001. We are claiming the entire amount as an outcome because the TAS did not have data available regarding the number of taxpayers assisted involving the EIC. Therefore, we could not determine how much of the \$2.2 million was directly related to the EIC.

The IRS may incur additional costs to incorporate additional procedures to ensure labor expenses are related to the EIC.

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Appendix V

**Fiscal Year 2000 Functional¹ Expenditures Using the
Earned Income Credit Appropriation**

Function	Amount Spent*
Communication and Liaison	\$ 1,458,153
Financial Operations	997,846
Submission Processing	13,187,710
Problem Resolution	1,017,256
Taxpayer Service Walk-In	3,601,817
Taxpayer Education	1,625,333
Criminal Investigation	27,161,739
Examination	12,375,942
Chief Counsel	976,859
Appeals	1,465,754
Customer Service	50,196,784
Information Systems	24,130,218
Telecommunications	2,751,826
Compliance Research	3,046,004
Electronic Tax Administration	6,759
Total Amount Spent	\$144,000,000

Source: The Automated Financial System report for the Earned Income Credit appropriation (0917) for Fiscal Year 2000.

*We did not verify the accuracy or reliability of the data in this report.

¹ Due to the Internal Revenue Service reorganization in October 2000, some of the functional names have changed.

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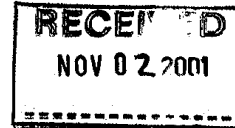
Appendix VI

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

NOV - 2 2001



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Better Controls Are Needed to Ensure Appropriated Funds Are Used to Improve the Application of the Earned Income Tax Credit (Audit No. 200140029)

In fiscal year 1998, the IRS established the EITC Program Office to administer the five-year EITC appropriation and oversee the EITC-related activities of IRS functions involved in ensuring the efficient application of the law, increasing the participation of eligible taxpayers, and reducing EITC overclaims. IRS has used this appropriation to improve the EITC program in many ways. We have:

- Revised all EITC taxpayer assistance products to emphasize determination of eligibility. We also revised the Form 1040 series instructions to enhance taxpayers' ability to determine EITC eligibility. Since we implemented these changes, the EITC error rate has decreased significantly.
- Designated employees to perform EITC education and outreach activities in their communities.
- Implemented statutory authority (known as "math error authority") to correct returns with incorrect EITC claims when we can identify the error during our initial processing of returns. Our research shows taxpayers generally do not repeat these errors in subsequent year filings.
- Implemented a "pre-refund" examination process. For errors we can correct only through deficiency procedures, we select returns during the filing season and hold any refund until we complete the examination.
- Developed a database that uses third party information such as child custody records to determine which returns to select for examination of questionable EITC claims.
- Implemented a multi-year, integrated strategy to educate tax return preparers about common EITC errors and to examine preparer practices and propose appropriate penalties. This program will have significant impact because paid preparers process more than 60 percent of all EITC returns.

Each year, the EITC Program Office staff, in conjunction with their counterparts in the functions, develops and monitors a plan that summarizes how the EITC appropriation will be spent. Your report, "Better Controls Are Needed to Ensure Appropriated Funds Are Used to Improve the Application of the Earned Income Tax Credit," acknowledges

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that IRS correctly expended EITC appropriated funds for travel expenses during the period audited. We disagree, however, with your finding that we spent approximately \$28 million of EITC funds on questionable labor and equipment purchases. We disagree with the value of the outcome measure described in your report.

Our comments on the expenditures in question follow:

- **Social Security Administration/Lamaze Partnership (Approximately \$557,000)** – We provided these funds to SSA to support their public information campaign for their Enumeration at Birth (EAB) Program. Under the EAB Program, parents of newborns can apply for their newborn child's Social Security number while still in the hospital. As part of the application process, the parents provide their SSNs. Under the Taxpayer Relief Act of 1997, SSA gives this data to IRS, where we use it to confirm the SSNs of parents and their EITC qualifying children. SSA developed EAB posters and revised a leaflet to promote this valuable service to expectant parents. In addition, SSA worked with Lamaze to produce an information video and an informational package for expectant parents, including the EAB leaflet. Lamaze childbirth educators use and distribute these items in their childbirth classes. These SSA products do not mention the EITC, but clearly the IRS and the EITC Program directly benefit from the success of the EAB Program. We stand by our decision to provide funds to the SSA for this partnership.
- **Computer Equipment for IRS Volunteer Programs (Approximately \$7 million)** – IRS records show just over \$5.5 million in EITC funds went toward computer-related purchases for volunteer programs (VITA and TCE). While the written justifications accompanying the requisitions for these purchases do not emphasize their connection to EITC, IRS made these purchases based on verbal directives and support provided by the highest levels of IRS management. In addition, IRS personnel discussed the justifications for these purchases in numerous meetings and telephone conversations. Giving the VITA program more computers provides additional e-filing capability, leading more low income taxpayers to seek out free income tax assistance and e-filing rather than going to a paid preparer. The more taxpayers use VITA and e-filing, the better chance we have of ensuring the accuracy of more EITC claims. We cannot dedicate VITA computers for EITC use only. When a taxpayer walks into a VITA site, a volunteer has no way to know that person's eligibility for the EITC until preparing his return. If a volunteer uses a VITA computer to show a taxpayer's ineligibility for the EITC, an EITC overclaim may very well have been prevented. We stand by our decision to provide funds for computer equipment for IRS volunteer programs.
- **Computer Equipment/Software for Testing Fraud System (Approximately \$2 million)** – To identify fraudulent and erroneous claims for the EITC, the Service had to develop and test systems providing that critical functionality.

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- Computer Software for Preparing Taxpayer Correspondence (Approximately \$39,000) – IRS purchased this software to clean, code, and standardize address data for taxpayer mailings in order to enhance the delivery of mail and obtain cost savings from postal discounts and incentives. During the period audited, IRS mailed over 1.7 million EITC specific notices and letters. In addition, IRS mailed over 50 million non-EITC specific notices, letters, and tax packages during this period. The vast majority of these items, e.g., the tax packages, while not EITC specific, included significant amounts of EITC material. This purchase helped all EITC taxpayers, and as a by-product, helped other taxpayers. We stand by this purchase.
- Fraud Detection Centers/Labor (Approximately \$16.2 million) -- The accepted baseline among the Service, Treasury, and GAO has been that approximately 70 to 75% of the fraud identified by the Office of Refund Fraud/Refund Crimes has some level of association/involvement in the Earned Income Tax Credit (EITC). A coordinated and accepted practice among the EITC Program Office, Chief Financial Officer, Chief Compliance, and Chief Criminal Investigation was to charge time for the Chief, Criminal Investigation Branch/Resident Agent in Charge, managers, court witnesses, and clerks to Appropriation 0913 (Tax Law Enforcement). The fraud detection staff would charge time to Appropriation 0917 (EITC). This approximates the 70/30 split in the charging of time among the Fraud Detection Center staff members, as a whole.
- Taxpayer Advocate Service (TAS)/Labor (Approximately \$2.2 million) – TAS does not associate specific hours on the Work Processing and Control (WP&C) with specific employees; the National Treasury Employees Union (NTEU) considered this a major issue during negotiation of the Single Entry Time Reporting (SETR) and WP&C implementation. TAS committed to the NTEU that it would not use SETR/WP&C to track hours by individual employee, nor would TAS use SETR/WP&C to associate specific hours worked with specific taxpayer cases. As a result, TAS does not load volume data onto WP&C. TAS uses the Taxpayer Advocate Management Information System (TAMIS) for case inventory control. While TAS cannot prove with certainty which (and how many) hours belong to a particular EITC case, the TAMIS inventory analysis reflected an underreporting of the number of EITC cases and time expenditures in the IRS financial system. As a result, TAS developed more specific guidance modeled on the Accounts Management methodology, and will disseminate the guidelines to all TAS employees following review and approval by the appropriate authorities. In order to improve and perfect time reporting, TAS will issue new guidelines for FY 2002 to all TAS employees on the proper use of the EITC reporting codes. TAS established review requirements to verify employee understanding of the new guidelines and use of EITC codes.

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Our comments on the specific recommendation in your report follow:

IDENTITY OF RECOMMENDATION

The Commissioner, Wage and Investment Division, should establish procedures to ensure that funds appropriated by the Congress for the improved application of the EITC are used for that purpose. These procedures should include providing guidance to the appropriate functions on using the EITC-related funds for expenditures, maintaining reliable data, and conducting periodic reviews of the expenditures to ensure they are being used for EITC-related items.

ASSESSMENT OF CAUSE

The EITC Program Office and the CFO devote a great deal of time and resources each year into the development of a detailed methodology book, the Financial Operating Guidelines, which directs each business unit how to charge obligations to the EITC appropriation.

CORRECTIVE ACTION

The EITC Program Office redesigned the EITC Request Form used to request realignment of EITC funds and to request additional resources. The EITC Program Office now requires additional coordination and approvals before authorizing the expenditure of EITC funds. The revised form and procedures have been placed on the CFO website in the FY 2002 Financial Operating Guidelines and discussed with the functional EITC coordinators via conference call.

IMPLEMENTATION DATE

Completed October 3, 2001

RESPONSIBLE OFFICIAL

Commissioner, Wage and Investment

CORRECTIVE ACTION MONITORING PLAN

Not applicable.

If you have any questions or need additional information about this response, please contact me, or you may contact Candice Cromling, National EITC Program Manager, at (202) 622-5994.